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**Managing the Impact of the Global Economic Crisis –
Private Sector Perspectives on Regulation**

Paper for the Commonwealth Secretariat*

Commonwealth Secretariat
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EXECUTIVE SUMMARY

The global financial crisis has prompted a necessary and constructive global debate regarding causes and cures. This paper examines the crisis from the perspective of the financial industry, focusing on a few key areas including securitization, credit derivatives and gaps in regulatory oversight. It discusses the role each of these played in the crisis, steps the industry is taking to enhance market practices and industry views regarding specific regulatory reform proposals. It concludes with recommendations for meaningful and effective reform.

2. While the causes of the crisis were many and complex, three factors routinely cited as contributing to or exacerbating the crisis are worth examining in more detail in order to understand and assess the potential effectiveness of industry or regulatory curative actions. Those three factors are: the role of securitizations as a catalyst for excessive lending and the deterioration of underwriting standards; the systemic concerns caused by the interconnectivity of credit risk in the derivatives markets; and the inability of a fragmented regulatory system to spot the warning signs and swiftly react to the crisis.

3. In responding to the crisis, even ahead of many regulatory changes, the financial industry has led initiatives to restore confidence in the financial markets. Initiatives to address the securitization markets involve issuers and investors as well as financial intermediaries and are focused on the residential mortgage market. In the Over the Counter (OTC) derivatives market, the major global dealers have been closely engaged with their supervisors to improve risk management, processing, transparency and systems and procedures. The industry is also committed to engaging with international standard setters and national supervisors on how best to deliver a more effective capital regime. Banks generally agree that implementing Basel II, reducing procyclicality (including dynamic provisioning), and improving liquidity management will lead to a more effective capital system, though the details are complex and will take time to address.

4. Globally, the G20 has led the way in focusing attention on regulatory gaps and building consensus among policy makers and regulators on creating a better framework for financial regulation that would include meaningful macro-prudential systemic risk regulation and oversight. Further, reform proposals are being advanced in the US, European Commission and on a national basis. In crafting these reforms, it is important to reflect the global nature of financial markets. Risk cannot be defined or contained by geographic borders. Investors around the world invest in multiple markets directly or through financial intermediaries. Reforms that are perceived as protectionist or which are created or implemented unevenly will undermine the ability to assess and oversee systemic risk globally and will create regulatory arbitrage opportunities. Some proposals being discussed in the US and EU could fall into this trap.

5. While the task at hand cannot be underestimated, there is an historic opportunity to drive meaningful change. The greatest risk now is that the lessons of the crisis will fade from memory before we are able to seize this opportunity.

Recommendations:

For Finance Ministers:

- 1. Governments should ensure their regulators can deliver improved macroprudential supervision; structures of regulation and the mix of responsibilities between central banks and supervisory authorities will differ, but the objectives should be the same: the establishment of systemic risk supervision, global regulatory co-operation, improved sharing of supervisory information and the development of supervisory colleges, coordination of responses to emerging crises and greater harmonization of rules.**
- 2. Governments should enact appropriate regulation of securitizations and Over the Counter (OTC) derivatives, focusing on sound market infrastructure such as central clearing, while taking into consideration the benefits of innovation and the importance of access to capital market financing.**
- 3. Governments should ensure the necessary powers are in place to handle the insolvency or potential insolvency of major institutions with minimum impact on financial stability.**
- 4. Governments should ensure that reforms do not create protectionist barriers and are implemented evenly to enable effective oversight of systemic risk globally.**

For Industry:

- 5. Industry should implement higher standards to address concerns and restore confidence in the securitization market, particularly focused on the residential mortgage market; and improve risk management, processing, transparency, systems and procedures for the OTC derivatives market, in particular by expanding the role of central clearing.**
- 6. Industry should work with the authorities to minimize the impact of insolvency, such as that of a prime broker, and focus on improving the speed of access to customer assets in the event of future firm failure.**
- 7. Industry should strengthen its corporate governance practices to address weaknesses identified through the financial crisis. In particular, industry should improve the governance and effectiveness of risk management systems and reform compensation practices.**
- 8. Industry should continue to raise the level of high quality capital and work with regulators to deliver a more stable prudential framework that is less procyclical and that adequately captures significant risk such as liquidity.**

For its part, the Commonwealth Business Council stands ready to work in collaboration with governments and the private sector to achieve these common objectives.

Managing the Impact of the Global Economic Crisis: Private Sector Perspectives on Regulation

Introduction

The financial crisis has been global in scope and wrenching in its severity. It has fuelled a necessary and constructive global debate regarding causes and cures. This paper examines the crisis from the perspective of the financial industry. It does not attempt to discuss all of the factors that have contributed to the crisis or all of the proposals for industry and regulatory reform. Instead, it focuses on a few key areas, including securitization, credit derivatives and gaps in regulatory oversight. It discusses the role each of these areas played in the crisis, steps the industry is taking to enhance market practices and industry views regarding specific regulatory reform proposals. The paper concludes with a number of observations and recommendations for meaningful and effective reform.

Origins of the Crisis

2. The origins of the crisis will be debated for generations to come. There are many differing opinions as to the root causes. Government monetary policy, gaps in regulatory oversight, rapid financial innovation and even outright fraud all played a role. While the causes were certainly many and complex, three factors routinely cited as contributing to or exacerbating the crisis are worth examining in more detail in order to understand and assess the potential effectiveness of industry or regulatory curative actions. Those three factors are:

1. the role of securitizations as a catalyst for excessive lending and the deterioration of underwriting standards;
2. the systemic concerns caused by the interconnectivity of credit risk in the derivatives markets; and
3. the inability of a fragmented regulatory system to spot the warning signs and swiftly react to the crisis.

Role of Securitization

3. The securitization market is often cited as having acted as a catalyst for the swift expansion in mortgage – particularly subprime – lending and the deterioration of underwriting standards that ultimately played a central role in the crisis. Many factors contributed to the explosive growth of securitizations over the last several years.

4. One key factor was the extended period of low interest rates in global financial markets. A global boom in savings resulted in large flows of capital into the U.S. and other markets, pushing down long-term interest rates and boosting asset prices. Central banks adopted policies to keep interest rates low and credit flowing. The extended period of low interest rates and low interest rate volatility drove increased investor demand for yield. This in turn drove the demand for, and supply of, innovative structured credit products paying relatively higher yields.

5. An abundance of inexpensive credit fueled an asset price bubble in residential housing and commercial real estate markets globally. The long period of home price appreciation encouraged borrowers, lenders and investors to make choices that could succeed only if home prices continued to appreciate. Loan origination volumes surged, and banks that originated mortgages and other debt assets were encouraged in part by regulatory capital requirements to get them off their balance sheets.

6. Securitization proved to be a highly efficient method of providing the financing needed to meet the needs of a growing mortgage origination and commercial real estate market and to remove loans from bank balance sheets. Innovation focused on originating, packaging, trading and distributing securitized products, particularly those related to subprime residential mortgage-backed securities. Illustrating their popularity as investment assets, tranches of residential mortgage securitizations were held widely across the globe. Over time as these products became more ubiquitous, subprime securitization tranches were incorporated as assets underlying other securitizations or structured finance products.

7. In hindsight it appears that at least some investors focused more on yield relative to rating than on doing their own assessment of the credit and liquidity risks of these products. Investors were often unable or unwilling to conduct an independent credit analysis and relied heavily on rating agency assessments. This was not an entirely irrational reliance as governments and regulators also relied heavily on ratings for numerous purposes and the complexity of the underlying transactions made analysis challenging.

8. It is now apparent that rating agencies, for their part, did not accurately assess the risks of many of these products. The models relied on in assessing structured products grew to reflect the complexity of the structured products and underlying assets, but still relied on basic assumptions about home prices and loss probabilities that proved to be wrong.

9. The strong demand for mortgage loans from securitization vehicles also contributed to a deterioration in mortgage underwriting standards. Underwriting risk and responsibility became diffused across the different parties in the mortgage chain. As underlying mortgages began to show signs of credit weakness, the securitizations built on top of them began to crack. Mark to market losses and liquidity strains escalated as housing prices fell and delinquencies rose. With the bankruptcy of Lehman and credit downgrade of AIG in the fall of 2008, interbank money markets seized up. Clients and trading counterparties became concerned about the solvency of banks that had large markdowns and either ceased doing business with them or demanded additional collateral. The impaired ability of financial firms to extend credit and conduct business contributed to a global economic downturn, creating a feedback loop between the banking system and the economy.

Role of Credit Risks Associated with Derivatives

10. Along with the growth of securitizations, over-the-counter or OTC (i.e., non-exchange traded) corporate and asset-backed credit derivative volumes increased exponentially over the last several years. As trading terms for particular products became more standardized and as index products such as the CDX, iTraxx and ABX were introduced, credit derivatives became a more efficient and effective trading vehicle than the underlying reference securities. The outstanding notional amount of credit derivatives written on a particular issuer was routinely a multiple of the principal amount of the issuer's securities. Credit derivatives were used by dealers and other market participants both to hedge risk and to establish directional risk positions.

11. Credit exposures between derivatives counterparties were typically mitigated by agreements between the parties that require the posting of collateral. However, some counterparties were sufficiently highly rated that a party felt comfortable taking credit exposures without requiring collateral (e.g., monoline insurers, AAA-rated derivatives products companies). Even where collateral arrangements were in place with a counterparty, significant and sharp market movements right before or after a counterparty default could

leave a party exposed as the collateral held by the party became insufficient to cover the cost of the default.

12. The OTC derivatives market was largely unregulated. While many key market participants were regulated entities, no regulator singly or acting in concert with other regulators would have had access to a complete picture of the marketplace. Aggregate volume, exposures and other key metrics could only be estimated. The connectivity between dealers and major OTC derivatives players was also impossible to precisely measure.

13. Against that backdrop, as losses and liquidity concerns arose for key financial players in 2007 and 2008, parties to derivatives contracts became very concerned about exposure to their trading counterparties. It became apparent in the fall of 2008 that dealers and other large market participants held significant amounts of risk on balance sheet through derivatives written on or with structured finance vehicles. Such positions, which were difficult to value in ordinary times, amplified counterparty liquidity and default concerns for these institutions. OTC derivatives market participants began to ask each other for more collateral and curtailed derivative and other activities that created credit exposures. Additionally, market participants began to purchase larger and larger amounts of credit derivative protection on financial institutions, increasing credit spreads and furthering the perception of a credit and liquidity crisis at these firms.

14. Regulators and certain market participants began to fear that a collapse of a major derivatives counterparty could ripple through the entire market, resulting in a cascade of defaults. Those concerns contributed to the freeze in the interbank markets and led to government interventions to shore up major financial institutions. The bankruptcy of Lehman Brothers illustrated the interconnectivity of the OTC derivatives market and resulted in major disruptions across multiple markets as millions of OTC trades were simultaneously unwound.

Role of Fragmented Regulatory Structure

15. The financial crisis exposed significant weaknesses and gaps in the regulatory oversight of the financial system. Certain institutions were overseen by multiple regulators under multiple regimes, but nonetheless managed to take on risks that left the institutions vulnerable. Supervision was conducted on institutions, not across industries or risk type. In hindsight, warning signs existed but no single regulator had access to sufficient information or was tasked with the role of putting the pieces together.

16. It is clear now that no regulator was responsible for looking across the financial industry to identify patterns, practices or nascent risks that could have a destabilizing effect on the overall financial system. Regulatory oversight was conducted institution by institution, not across the industry. Where industry wide surveys or examinations were undertaken by regulators, it was typically to identify best practices for a particular area or product, not to uncover potential systemic risks.

17. Many regulators, particularly in the U.S., necessarily focused on the particular legal entity or entities under their jurisdiction, rather than the financial institution as a whole. This resulted in certain aspects of a financial firm's activities being overseen by multiple regulators, while other aspects were left largely or completely unregulated. A large financial institution typically would assess and manage risk on an aggregated basis across all of its legal entities. A regulated entity within a large financial institution would also typically examine and manage risk at that entity; however, the risk profile of any particular regulated

entity within a large financial institution would unlikely have approximated the risk of the entire organization. Regulators reviewing risk management of an institution by examining the individual risk of its regulated entities would be left with an incomplete view of how risk was managed across the institution. As the crisis has illustrated, relatively small groups of employees booking risk to an unregulated entity had the potential to escape regulatory scrutiny, but were able to put their institutions at extraordinary risk.

18. Even where regulators spotted weaknesses or warning signs, appropriate follow through did not always occur. A U.S. Government Accountability Office report on Financial Regulation from March 2009 cites examples of regulators identifying weaknesses in risk management systems, validation of models and senior management oversight, yet failing to fully appreciate the magnitude or potential implications of these weaknesses. Regulators – and many others – tended to view risk through a historical lens, focusing most on the issues that had occurred before and using historical data to shape views of likely future events. Regulators were not alone in failing to critically assess the future validity of assumptions that were based on historical data. The prolonged economic expansion and technical sophistication of the financial models fostered a sense of complacency and muted reactions to the warning signs.

19. Fragmented regulatory structures encouraged a myopic view of the particular risks a regulator oversaw. The regulatory framework could not keep up with the rapid pace of innovation and complexity in both the products and global financial institutions. The financial system operated with gaps in meaningful oversight and without sufficient regulatory tools to measure, assess and address risk.

Key Industry Initiatives

20. Even ahead of many regulatory changes, the industry has led initiatives to restore confidence in the financial markets.

Securitization Markets

21. The global securitization industry has launched a number of initiatives to restore confidence in and restart the securitization market. These initiatives involve issuers and investors as well as financial intermediaries and are focused on the residential mortgage market. For instance, the Australian Securitization Forum, the American Securitization Forum, the European Securitization Forum and the Securities Industry and Financial Markets Association (SIFMA) published a report as a Global Joint Initiative that identified industry priorities for immediate action to restore confidence in the securitization market.

22. Industry-wide initiatives are focusing on those aspects of securitization which are generally considered in the wider politico-economic sphere to have contributed to the global credit crisis, such as the widely criticized “originate-to-distribute” model and over-reliance on third party credit assessments. Key industry initiatives are being designed to:

- enhance initial and on-going underlying pool information on residential mortgage securitizations and disclose information in a more accessible and standardized format;
- strengthen industry-wide market standards of due diligence, disclosure and quality assurance practices;
- strengthen and standardize representations, warranties and repurchase obligations of loan originators;
- improve independent, third-party sources of valuations and valuation infrastructure;

- improve transparency, reliability and understanding of rating agencies and their ratings;
- establish a Global Securitization Markets Group to report publicly on the state of the market and changes in market practices; and
- establish educational programs for directors and executives with oversight over securitized and structured credit groups, as well as for investors with significant exposure to these products.

23. Similarly, the American Securitization Forum launched Project RESTART (Residential Securitization Transparency and Reporting) in July 2008. Project RESTART is a collaborative effort by the securitization industry to identify and pursue actionable solutions designed to revive and promote a well-functioning securitization market. This initiative aims to enhance securitization best practices including standardization and expansion of existing issuer disclosure for residential mortgage securitizations, enhanced due diligence and quality assurance protocols, standardization of representations and warranties and repurchase arrangements, and participation in loan modification programs including HAMP (Home Affordable Modification Plan). HAMP is the Obama administration's effort to help at risk homeowners by facilitating modification of mortgage loans by servicers to avoid foreclosures. It does this by establishing certain protocols for mortgage loan servicers to identify borrowers who are at imminent risk of default and providing incentive payments to borrowers, servicers and lenders who effect modifications in accordance with HAMP.

OTC Derivatives Markets

24. In the OTC derivatives market, the major global dealers have been closely engaged with their supervisors to improve risk management, processing, transparency, and the systems and procedures for carrying on OTC derivatives business since 2005. More recently, the dealers have been involved in extensive discussion with the Federal Reserve in the U.S. and with the European Commission and European Central Bank to make specific concrete improvements to market infrastructure.

25. Over the last year, centralized clearing of credit derivatives has been a major focus for credit derivatives dealers. Done properly, centralized clearing reduces systemic credit risk by concentrating member credit exposure to a single, well capitalized entity subject to regulatory oversight. However, the concentration of credit risk with a clearinghouse has the potential to enormously increase systemic risk were the clearinghouse to fail. The ability to accurately value cleared trades is critical to the clearinghouse's ability to calculate appropriate margin levels, and to therefore ensure it can survive a member default.

26. In order to achieve centralized clearing for corporate credit derivatives, critical changes to the terms of those contracts were necessary in order to make contracts standardized and fungible. Through ISDA-sponsored industry initiatives, those changes were implemented earlier this year and ICE Clear U.S. and ICE Clear Europe are now clearing certain liquid corporate credit derivatives.

27. While clearing is currently available only to dealers who are members of the clearinghouse and only for a limited universe of products, the industry has committed to expanding the scope of cleared products as standardization, liquidity and technology allow. The dealers have also committed to enabling customer access to clearing through either direct access as a clearing member or via indirect access, including the benefits of initial margin segregation and position portability.

28. Other industry commitments in the OTC derivatives space include:
- improving collateral and margining processes, including portfolio reconciliations, metrics on position and market value breaks, and improved dispute resolution mechanics;
 - updating industry governance to be more inclusive of buy-side participants; and
 - continuing to drive improvement in industry infrastructure as well as to engage and partner with supervisors, globally, to expand upon the substantial improvements that have developed since 2005.

Other Industry Responses: Insolvency Protections

29. Industry responses to the crisis have not been limited to the securitization and OTC derivatives space. One area in particular worth highlighting relates to changes in business practices in the prime brokerage business to allay customer concerns regarding an insolvency of a prime broker.

30. The collapse of Lehman Brothers presented the industry and regulators with a particular set of challenges relating to the manner in which insolvency officials dealt with the return of client assets following the insolvency. The complexity of the process which an insolvency official must go through in order to be able to determine that assets may be released to a client was underestimated, in particular by the hedge fund industry. There is considerable disquiet in the UK over the length of time that it is taking for customers to access their securities held at Lehman Brothers. In response, the prime brokerage industry has taken steps to improve speed of access to customer assets in the event of a future firm failure. These include:

- the use of alternative custodial locations to hold “excess” securities (securities not currently required by the prime broker to support the obligations of the customer) which are designed to continue to operate despite the failure of the prime brokerage entity, and
- enhanced reporting with respect to client assets and exposure to the prime broker.

31. In addition the UK Treasury is consulting with the industry on the possibility of financial firms adopting formal failure management plans or contingency plans which are designed to ensure that the firm’s client asset systems, trading positions and reports can continue to operate post an administration or insolvency.

Industry Support for Reform

32. As the financial crisis deepened resulting in a global recession, consensus emerged that regulators and policy makers should create a better framework for financial regulation that would include meaningful macro-prudential systemic risk regulation and oversight. Such a regulatory framework would also address the need for a quick and coordinated response by the governments of the world’s major economies to avoid fragmentation regionally and globally. Certain illustrative reform proposals and the financial industry’s reactions are discussed below.

G20 Initiative

33. Globally, the G20 has led the way in focusing attention on regulatory gaps. Meeting in November 2008, the G20 leaders agreed that coordinated international action was needed to address the financial crisis and its underlying causes. The resulting statements from that meeting, and a second meeting in April 2009, embodied commitments from participating countries to strengthen the international financial regulatory framework. The G20 leaders established the Financial Stability Forum (now the Financial Stability Board) and expanded the role of the IMF.

34. At the November 2008 summit, the G20 leaders committed to the following key principles: strengthening transparency and accountability, enhancing sound regulation, promoting integrity in the financial markets, reinforcing international cooperation and reforming international financial institutions. The G20 leaders also set a clear mandate for the international standard setters under the aegis of the Financial Stability Board (“FSB”) which was to focus on matters including:

- addressing the need for systemic or macro- prudential oversight with the IMF;
- improving regulation of all systemic firms, including non banks such as hedge funds;
- increasing supervisory cooperation and effective supervisory colleges for cross border firms;
- improving resolution schemes and burden sharing arrangements for cross border firms;
- increasing capital requirements for trading activity and for liquidity risk;
- new capital buffers to counteract procyclicality effect, and possible leverage limits; and
- regulation of credit rating agencies.

35. Substantial progress has already been made on many of these initiatives by the FSB and by national and regional authorities around the globe as reported at the G20’s most recent meeting in April. The securities industry supported the establishment of the FSB and is hard at work on these and other initiatives, several of which are now completed.

U.S. Legislative Efforts

36. In the U.S., there is general industry support for the Obama administration’s proposals regarding the creation of a systemic risk regulator, regulatory oversight of all systemically significant institutions with attendant resolution authority for such entities, rating agency reforms, requirements for securitizers to retain some “skin in the game,” additional disclosure over the life of securitization transactions, and modification of delinquent mortgage loans.

37. The industry has also come out in support of the goals of the Obama administration’s proposals for reform of OTC derivatives and of similar legislative efforts across the EU. As discussed above, the industry is already moving to clear OTC corporate credit derivatives and has been clearing other OTC derivatives such as interest rate swaps for many years. Trade groups have publicly supported the adoption of rules regarding centralized clearing and the reporting to a data repository of all OTC derivatives that are not centrally cleared. There is general support for the concept that regulators have a necessary oversight and surveillance role in the OTC derivatives markets. In order to fulfill that role, regulators will need access to information and the ability to act on that information when necessary.

European Commission Initiatives

38. In Europe steps have been taken to ensure better coordination and consistency in financial services regulation. The European Commission has proposed the creation of:

- The European Systemic Risk Board (ESRB). It is envisioned that the ESRB would monitor and assess potential threats to systemic stability. It would provide early warnings of system-wide risks and issue non-legally binding recommendations to address them. The warnings and recommendations could be general in nature or could focus on individual member states.
- The European System of Financial Supervisors (ESFS). It is expected that the ESFS would replace the current level 3 bodies CEBS, CESR and CEIOPS. It is anticipated that its role would be to harmonize EU rules and deliver supervisory convergence but it would also have the power to issue binding decisions and to supervise some pan-EU entities like clearing houses.

39. The industry has welcomed these proposals and is working with the European Commission to ensure that any new rules or supervisory oversight would be applied consistently across the EU and in a manner reflecting the international wholesale nature of the financial services industry.

40. In addition the European Commission has recently published a draft Directive on Alternative Investment Fund Management which would require a manager which uses high levels of leverage to disclose to the manager's home state regulator the maximum level of leverage that will usually be employed and, on a regular basis, the total amount of leverage actually employed by the fund and its five largest sources of borrowed cash or securities. It is the Commission's intention that this information would be used to identify build-up of systemic risk and that the information will be shared among regulators if it believes that the manager could create material counterparty risk to an institution in another member state. More controversially from an industry perspective, the Commission is also proposing to impose limits on the aggregate amount of leverage that can be used by a fund manager. The limits would take into account the type of fund, its strategy and its sources of leverage. It is also proposed that additional leverage limits could be applied on a temporary basis to individual funds in exceptional market conditions.

UK Corporate Governance Review; Compensation Practices

41. The UK Government commissioned Sir David Walker to lead an independent review of corporate governance in the UK banking industry and other financial institutions. The report was compiled after four months of consultation with experts in the City of London who examined the effectiveness of board practices, the incentives in pay policy to manage risk, and the effectiveness of risk management. Sir David observed that the fact that banks operating in the same locations, in the same market environment and subject to the same regulation had such significantly different experiences in the crisis can only be explained in the context of how they were run. Accordingly although it would not guarantee that there would not be a repeat of the crisis, better corporate governance would make a rerun materially less likely. Sir David concluded that the Combined Code of the Financial Reporting Council which sets out standards of good practice in governance for UK listed companies remains fit for purpose but put forward 39 recommendations most of which could be incorporated as enhancements to the Code covering themes such as board size and qualification; the functioning of the board and evaluation of performance; the role of institutional shareholders; risk governance; and remuneration.

42. Compensation practices in the financial industry are receiving justifiable attention across the globe. The industry, while resisting outright caps and punitive taxation, supports reform of the compensation structure. Many firms have either publicly supported or already adopted measures to better align risk and reward, such as tying compensation to multi-year performance and instituting clawback provisions.

Regulatory Capital

43. While public injections of capital have been made into financial institutions, firms have also made significant progress in raising capital levels through private investment and have proactively reduced the size of their balance sheets to reduce risk and improve capital ratios. The industry is committed to engaging with international standard setters and national supervisors on how best to deliver a more effective capital regime. Banks broadly share the following consensus on how to achieve this:

- ***Implementation of Basel II.*** The industry agrees with the G20 that Basel II remains the best framework for setting regulatory capital requirements. The reforms already proposed regarding capital buffers, liquidity risk and leverage ratios will deliver significant capital increases. Care needs to be taken that the cumulative effect does not lead to excessive capital requirements which could impact investment.
- ***Need for Clarity Regarding Procyclicality.*** The industry is generally supportive of reducing procyclicality, including possible capital buffers or dynamic provisioning, but there is as yet no consensus on how to achieve what is in fact a difficult technical goal. If there are to be such buffers or reserves, it is of fundamental importance that they in fact be available to be reduced in economic downturns. This requires buy-in from investors and the rating agencies. The likely need for discretionary mechanisms, given the different economic cycles in different countries combined with the need for a level playing field internationally suggest that care be taken to ensure the process is as objective, predictable and transparent as possible.
- ***Liquidity Rules Must Be Carefully Crafted.*** Firms have already taken significant steps to improve management of liquidity, including ensuring that local liquidity needs can be met, using conservative assumptions and setting limits locally. Care needs to be taken that new measures to require local “trapped liquidity” do not hinder sensible risk management and introduce unnecessary rigidity. This is particularly important for cross border firms, who need the flexibility to manage their business globally.

Conclusion and Recommendations

44. Restoring the health of the global financial system is vital to restarting economic growth. To bolster international capital markets and ensure robust levels of sustainable economic growth, regulators as well as the industry recognize that it is imperative that financial firms be able to operate effectively and efficiently across borders without material regulatory divergence which would distort competition and foster regulatory arbitrage. Even for countries in many emerging markets who have escaped much of the direct fallout from the crisis, it remains important to have stable domestic and international banks to ensure trade finance and other forms of cross border capital flows continue to finance investment and real economic growth.

45. To assure we have a strong and stable financial system going forward, both the industry and the regulators should seize this opportunity for fundamental reform. Key, achievable reforms include:

- ***Establishing systemic risk regulators for countries or regions.*** The financial crisis made clear that regulators both regionally and globally simply did not have the tools or the authority to protect the stability of the financial system as a whole. Our current, fragmented regulatory structure has not kept pace with the increasingly complex and global markets. We should establish systemic regulators with the ability and the responsibility to ensure that risk taking never again reaches the point of jeopardizing the entire financial system. The systemic risk regulators for countries or regions should facilitate global regulatory cooperation, share information, coordinate a swift global response to emerging crises and strive to achieve greater harmonization of relevant rules.
- ***Enacting appropriate regulation of securitizations and OTC derivatives.*** OTC derivatives and securitization play a critical and central role in modern financial markets. Additional regulatory oversight of these products is warranted and regulators need a clearer picture of the risks posed by derivatives and complex financial instruments. However, oversight of these products and markets must take into consideration the benefits of innovation and be flexible enough to accommodate change.

46. In crafting these reforms, participants cannot lose sight of the fact that financial markets are global in nature. Risk cannot be defined or contained by geographic borders. Individual banks, securities firms, insurance companies, hedge funds and other financial institutions operate in all major markets around the world. Investors around the world invest in multiple markets either directly or through financial intermediaries. Reforms that are perceived as protectionist or which are created or implemented unevenly will undermine the ability to assess and oversee systemic risk globally and will create regulatory arbitrage opportunities. Certain proposals being discussed in the U.S. and EU could fall into this trap.

47. While the task at hand cannot be underestimated, there is currently an historic opportunity for the industry and its regulators to work together to drive fundamental, meaningful and necessary change. Perhaps the greatest risk now is that the lessons of the crisis will fade from memory before we are able to seize this opportunity.

Recommendations:

For Finance Ministers:

1. Governments should ensure their regulators can deliver improved macroprudential supervision; structures of regulation and the mix of responsibilities between central banks and supervisory authorities will differ, but the objectives should be the same: the establishment of systemic risk supervision, global regulatory co-operation, improved sharing of supervisory information and the development of supervisory colleges, coordination of responses to emerging crises and greater harmonization of rules
2. Governments should enact appropriate regulation of securitizations and Over the Counter (OTC) derivatives, focusing on sound market infrastructure such as central clearing, while taking into consideration the benefits of innovation and the importance of access to capital market financing
3. Governments should ensure the necessary powers are in place to handle the insolvency or potential insolvency of major institutions with minimum impact on financial stability.
4. Governments should ensure that reforms do not create protectionist barriers and are implemented evenly to enable effective oversight of systemic risk globally.

For Industry:

5. Industry should implement higher standards to address concerns and restore confidence in the securitization market, particularly focused on the residential mortgage market; and improve risk management, processing, transparency, systems and procedures for the OTC derivatives market, in particular by expanding the role of central clearing;
6. Industry should work with the authorities to minimize the impact of insolvency, such as that of a prime broker, and focus on improving the speed of access to customer assets in the event of future firm failure
7. Industry should strengthen its corporate governance practices to address weaknesses identified through the financial crisis. In particular, industry should improve the governance and effectiveness of risk management systems and reform compensation practices
8. Industry should continue to raise the level of high quality capital and work with regulators to deliver a more stable prudential framework that is less procyclical and that adequately captures significant risk such as liquidity.

For its part, the Commonwealth Business Council stands ready to work in collaboration with governments and the private sector to achieve these common objectives.